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Sandpiper Capital

Gleanings

A Tale of Two Realities

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"On a national income basis, for the entire U.S. corporate sector as reported by the Bureau of Economic Analysis, year to date after tax corporate profit at an annualized $1.4 trillion are the highest that they've ever recorded."

It was the best of times…. Second quarter earnings of $20.73 for the companies that constitute the S&P 500 were ahead of expectations, double the first quarter of 2009 and 7% higher than the $19.38 reported in March. For the 5,639 publicly traded companies in the Bloomberg earnings database, last quarter's aggregate $251 billion in net income was the second highest quarter on record. On a national income basis, for the entire U.S. corporate sector as reported by the Bureau of Economic Analysis, year to date after tax corporate profits, at an annualized $1.4 trillion, are the highest that they've ever recorded.

With credit markets proving a ready source of low cost debt financing, today's subsidized interest rates have afforded companies a tremendous opportunity to refinance existing debt. Credit rating upgrades provide a good reflection of just how constructive the markets have been, with the ratio of upgraded ratings to downgraded the best in a decade.

Market Returns through 09/30/2010

Index	2008	2009	YTD
S&P 500	-36.9	26.5	3.9%
ML 1-10 yr Gov't/Corp	4.1	5.7	7.6%
EAFE (Developed Mkts)	-43.3	31.8	1.1%
Emerging Markets	-53.2	78.5	10.8%

It was the worst of times…. Wage and salary income at $6.3 trillion is $250 billion less than two years ago and at a fifty year low as a proportion of national economy. The unemployment rate for female headed households, African Americans and those without a college education is still double normal levels and at or near thirty year highs. Homeowner's equity per household is half of what it was at the peak in 2006 and adjusted for inflation is less than it's been at any time since 1978. One out of five children live in households with income below the poverty level and the number of people on food stamps in Virginia Beach has almost doubled in the last ten years.

Market valuations are reflective of broad economic conditions. The net flow of funds out of stocks and into money funds by retail investors is the logical response to the everyday economic reality that most of us are facing. It is entirely possible that valuations going forward, that is; the price that the markets are willing to pay for a dollar of S&P earnings, will stay subdued until the broad economy starts to show some growth. As long as incomes, net worth and retail credit are flat, higher reported earnings may well be met with the same lack of enthusiasm market participants have been showing to date.

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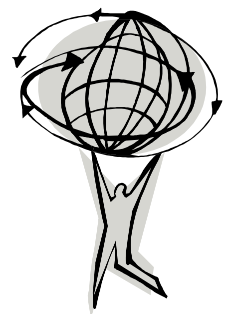
Our S&P valuation model is largely driven by reported earnings. The presumption has been that most of the volatility around a central value that the market has exhibited historically was influenced by so many different factors in so many ways that divining which were the most important was impossible. We were happy to just tell cheap from dear.



In an attempt to answer the question, “Can we predict the move from fear to greed?”, we looked back at the factors that we referenced in last year’s Gleanings - “Four Lanes Blocked”. When we extract the relative values from our S&P valuation model above, (the purple line which indicates how much above or below fair value that the market has traded), and superimpose the growth over time of the combination of incomes, net worth, exports and loans (our “powder index”), we can see how the expansion or contraction of those factors influences the price people are willing to pay for the S&P. When powder recedes, so does optimism. Given the direction of and immediate prospects for incomes, net worth, loans and exports, we are tempering our enthusiasm for adding money to what is an objectively cheap market.